

Your TSP contributions are either "tax-deferred" or "tax -exempt," depending on the type of pay from which they are derived. You make tax-deferred contributions from your taxable pay. You make tax-exempt contributions from pay you earn that is subject to the combat zone tax exclusion.

Earnings attributable to TSP contributions are also always tax-deferred, even if attributable to tax-exempt contributions

## **TAX-EXEMPT CONTRIBUTIONS**

When you serve in a combat zone or qualified hazardous duty area, most compensation you receive for active service is excluded from your gross income on your IRS Form W-2, regardless of whether you contribute any of it to the TSP. All of an enlisted member's and warrant officer's compensation is eligible for the combat zone tax exclusion. Officers, however, may exclude no more than the highest rate of basic pay paid to each service's senior enlisted member (in 2003 this amount is \$5,882.70 ) and any hostile fire/imminent danger pay received by the officer.

In some cases, members who are serving outside a combat zone or qualified hazardous duty area but are directly supporting operations in such a zone or area can also qualify for the combat zone tax exclusion.

You receive no direct tax benefit from contributing pay to the TSP which has been excluded from gross income; however, the earnings on those contributions are tax-deferred.

When you make a withdrawal, money is taken from your total account balance proportionally from your taxable funds and your tax-exempt funds. The amount attributable to tax-exempt contributions will **not** be taxable.

Your service will notify the TSP whenever your contributions are from tax-exempt money. The TSP will then account for your tax-exempt contributions and, as indicated above, will ensure that these amounts are not reported to the IRS as taxable income. Consequently, those contributions will not be subject to taxation when you withdraw them. Your quarterly participant statement will show your tax-exempt balance separately.

Your service can tell you more about combat zone/qualified hazardous duty area service and whether you qualify for the tax exclusion. (See also IRS Publication 3, *Armed Forces' Tax Guide*.)

## **TAX-DEFERRED CONTRIBUTIONS**

There are two tax benefits to making tax-deferred contributions to the TSP:

- Your TSP contributions are taken out of your pay before taxes are withheld, so you pay less tax now.
- Taxes on contributions and attributable earnings are deferred until you withdraw your money.

### **What are the immediate benefits of making tax-deferred contributions to the TSP?**



Tax-deferred contributions are "before-tax" contributions. In other words, the money you contribute is taken out of your pay before Federal and, in almost all cases, state income taxes are withheld. Therefore, the amount used to calculate your taxes is smaller, so you pay less in taxes now. Deposits to a regular savings account do not provide such an advantage.

Your TSP contributions are excluded from the taxable income reported on the IRS Form W-2, Wage and Tax Statement, that you receive from your service each year. Thus, you do not report them on your annual Federal tax return. This special tax treatment does not affect your salary of record for other Federal benefits — such as uniformed services retired pay — nor does it affect Social Security or Medicare taxes or benefits.

By paying less current income tax, you have more take-home pay than if you had saved an equal amount that was not excluded from taxable income. To give you an idea of the advantage of saving through before-tax contributions to the TSP, let us suppose, for simplicity, that you earn \$30,000 a year and that you are in the 15 percent tax bracket. If you contribute 5 percent each month (or \$1,500 per year) to your TSP account, you will **save \$225** in Federal taxes ( $15\% \text{ (your tax bracket)} \times \$1,500 = \$225$ ). If you had simply deposited the \$1,500 in a regular savings account, you would have owed \$225 in Federal taxes. Your tax savings will be even greater if the state in which you live (or of which you are considered a legal resident) allows you to exclude TSP contributions from taxable income, as most states do.

### **What are the long-term benefits of tax-deferred contributions?**



By participating in the TSP, you defer (that is, postpone) paying Federal taxes on the money you contribute until you withdraw the funds from your TSP account. In addition, over the years, the money in your account will accrue earnings. These earnings are also tax-deferred. This means that you do not pay income taxes on your TSP account contributions and earnings until you receive the money — usually after you retire (when your tax bracket may be lower).

Deferring the payment of taxes means that more money stays in your account, working for you. The longer your money is invested, the greater the benefit of tax-deferred earnings will be.